No. 56

In the

Supreme Court of the United States

October Term, 1945

KIRBY PETROLEUM COMPANY, *Petitioner*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT.

BRIEF FOR PETITIONER

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OTHER AUTHORITIES CITED

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I.

The Opinions of the Courts Below

The opinion of the Tax Court (R. 10) is reported in 2 T. C. 1258, and that of the Circuit Court of Appeals (R. 38) in 148 F. 2d 80.

II.

Jurisdiction.

Jurisdiction of this cause is conferred upon this Honorable Court by Judicial Code, Section 240, as amended; United States Code, Title 28, Section 347.

The judgment of the Circuit Court of Appeals was entered March 5, 1945. (R. 50.)

III.

Statement of the Case.

This cause was tried before the Tax Court on the pleadings (R. 2-10) and stipulation. (R. 22-36.)

Petitioner owned the *fee title* to a tract of land except that there was outstanding a 1/8 interest in the minerals. On September 29, 1927, it executed a regular oil and gas mineral lease (R. 24-29) upon the property reserving a royalty of 1/6 on oil and in substance 1/6 on the amount realized from the sale of gas. Out of its 1/6 royalty it absorbed the outstanding 1/8 interest so that its gross royalty was a net 1/24 [R. 4, par. (A) (6)]. On the same day it executed an agreement (R. 29-36) with the lessees, which recited the execution of the lease and provided that the lessees should also pay petitioner 20% of the net profits derived by the lessees from their operations under the lease and then provided in detail for the accounting procedure in the determination of the net profits. Both the lease and the agreement were executed by George Sawtelle, a Vice-President of petitioner. It was stipulated (R. 23-24) that he, if sworn, would testify that petitioner would not have executed the lease unless the lessees had also executed the contemporaneous agreement as a part of the consideration for petitioner's executing the lease, that the lessees did execute the agreement as a part of the consideration for petitioner's executing the lease, and that petitioner also received a cash bonus from the lessees for executing the lease. This testimony was uncontradicted.

Production was obtained in 1932, and in 1935 peti-

tioner received its first payment under its net profits agreement, and received such payments of profits for each year through 1940, the year involved. For 1940 its part of the net profits was $26,223.70, and in its income tax return for that year it deducted as depletion 27½% of this amount. The Commissioner disallowed this depletion deduction (R. 23, Par. 5). The Commissioner did not question its deduction for depletion on its 1/24 royalty.

Petitioner appealed to the Tax Court on this one point. The Tax Court in its opinion and decision (R. 10-17) held that petitioner was entitled to the depletion allowance, and held that in granting the lease the petitioner retained for itself the 1/6 oil royalty and 20% net profits from the operation of the lease each year. The Circuit Court of Appeals reversed the judgment of the Tax Court and apparently held that, although petitioner retained an economic interest in the oil and gas in place to the extent of the cash bonus and the 1/6 royalty, it nevertheless surrendered all of its other interest and retained no economic interest in the oil and gas in place by virtue of which it received 20% of the net profits but received this 20% merely as a result of its having a chose in action or economic advantage (R. 38, 40).

Judge Hutcheson filed a dissenting opinion (R. 44), holding that petitioner was entitled to the depletion allowance on the net profits to the same extent as it was on the 1/24 royalty and that the Tax Court should be affirmed.

In point A of our brief in support of our petition

for a writ of certiorari we raised the point as to whether the Circuit Court of Appeals was authorized to treat the lease and net profits agreement as two separate transactions when the Tax Court had treated them as one. The respondent in his Memorandum filed in connection with our petition stated on page 7:

> "Particularly, there is no warrant for the assertion (Pet. 4, 5, Br. 14-15) that the Circuit Court of Appeals treated the contemporaneous agreements as separate transactions while the Tax Court had determined that they were part of one transaction. Nothing in the opinion of the Circuit Court of Appeals suggests that it considered that, because the agreement to pay 20 percent of the net profits to the lessor was embodied in a separate document, it should be treated as a separate transaction or that it would have reached a different result if that agreement had been embodied in the lease. Both the Tax Court and the Circuit Court of Appeals arrived at their respecive conclusions without attaching any significance to the fact that there were two documents rather than a single one."

In view of this statement by respondent both parties are in accord that this transaction may be treated as if petitioner simply executed an oil and gas lease on its fee property and retained a royalty of 1/6 of the gross oil and gas and 1/5 or 20% of the net profits.

IV.

Questions Presented.

1. Whether the Circuit Court of Appeals had authority to make findings of fact and inferences of

fact contrary to those of the Tax Court and thereby hold that petitioner was not entitled to the depletion claimed.

2. Whether petitioner is entitled to the depletion allowance of 27½% upon the amount received by it under the 20% net profits provision.

V.

Statutes Involved.

Internal Revenue Code:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

> (m) *Depletion.*—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvments, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. In any case in which it is ascertained as a result of operations or of development work that the recoverable units are greater or less than the prior estimate thereof, then such prior estimate (but not the basis for depletion) shall be revised and the allowance under this subsection for subsequent taxable years shall be based upon such revised estimate. In the case of leases the deductions shall be equitably apportioned between the lessor and lessee. * * *
> (26 U. S. C. 1940 ed., Sec. 23.)

SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

* * * * *

(b)—*Basis for Depletion.*—

* * * * *

(3) *Percentage Depletion for Oil and Gas Wells.*—In the case of oil and gas wells the allowance for depletion under Section 23 (m) shall be 27½ per centum of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance under Section 23 (m) be less than it would be if computed without reference to this paragraph.

* * * * *

(26 U. S. C. 1940 ed., Sec. 114.)

VI.

Specification of Errors.

1. The Circuit Court of Appeals erred in substituting its findings of fact and inferences of fact contrary to those of the Tax Court and in thereby holding that petitioner was not entitled to depletion on the proceeds of the 20% net profits.

2. The Circuit Court of Appeals erred in holding that petitioner was not entitled to the depletion allowance on the amount received by it under the provision of its contract that it was to receive 20% of the net profits from the operation of the properties.

ARGUMENT.

Summary of the Argument.

Point A.

The Circuit Court of Appeals had no authority to make findings of fact and inferences of fact contrary to those of the Tax Court and thereby hold petitioner was not entitled to the depletion claimed.

Point B.

Petitioner at all times had an economic interest in the oil and gas produced and was entitled to the depletion allowance on the amount received by it under the 20% of net profits provision.

Point A.

The Tax Court in its opinion, after setting out the facts, summarized the contentions and distinctions made by petitioner (R. 14-15) and concluded in that part of its opinion as follows (R. 14):

> "In the instant case petitioner lays emphasis on the fact that it was the owner in fee simple of two tracts of land and leased them to Humble and to Marland for development and operation and that in granting the lease it retained for itself a 1/6 oil royalty and 20 per cent net profits from the operation of the lease each year. Respondent has not disputed petitioner's right to percentage depletion on the 1/6 oil royalty reserved in the lease but does dispute petitioner's right to percentage depletion on the $26,223.70 net profits which petitioner received in 1940 from operations.
>
> "Petitioner contends that it is as much entitled to depletion on this $26,223.70 as it is on the receipts from its 1/6 oil royalty and distinguishes its situation from that which existed in *Helvering*

v. O'Donnell, supra, and *Helvering v. Elbe Oil Land Development Co., supra,* and *Anderson v. Helvering, supra,* on the grounds which we have already stated. We agree with petitioner in the distinction which it draws."

In discussing what was the gross income under Section 114 (b) (3) of the Internal Revenue Code, the Tax Court said (R. 15):

> "What is petitioner's 'gross income from the property' in 1940 within the meaning of Section 114 (b) (3) and which it must include in its gross income for income tax purposes? We think it is clearly the proceeds from the 1/6 royalty which petitioner retained in the lease and the 20 percent annual profits which it received from the operation of the lease under the contemporaneous agreement amounting in 1940 to $26,223.70. If this view is correct, then petitioner is entitled to percentage depletion on the amounts received from its part of the profits as much as from the amounts received from its retained 1/6 oil royalty."

Judge Hutcheson in his dissenting opinion agreed with this analysis by the Tax Court, but the majority of the Court held that the lease and contract were entirely different transactions, that the petitioner reserved an economic interest represented by its 1/6 royalty but had no economic interest represented by the 20% of net profits, and for that 20% "accepted the personal covenant of the lessees to pay whatever amount of the net profits became due by the lessees."

We quote the following pertinent parts of the opinion of the Circuit Court of Appeals (R. 40):

"It is immaterial that the transfers here were accomplished by means of a lease; what is material is that the right of the taxpayer to share in the net profits was not derived from the retention of any depletable interest in the oil and gas in place.

"Prior to the execution of the lease and the agreement here involved, the taxpayer (with exception of the 1/8 interest mentioned) had the entire capital investment in the underlying oil and gas. To the extent of the cash bonus and the right to royalty payments, it retained a proportionate economic interest in the oil and gas in place, and to that extent the lessees did not acquire a depletable interest, but to the extent that the taxpayer granted exploration rights and an interest in the minerals in place to producers in exchange for their personal covenant to pay a share of their net profits, there was a conveyance of the taxpayer's interest in a wasting capital asset, and the producers acquired a proportionate depletable interest in the oil and gas conveyed. By surrendering a partial interest in the oil and gas produced from the property, the taxpayer converted a portion of its economic interest into a mere chose in action or economic advantage."

Incidentally, it is impossible to see how the lower court could make this distinction between petitioner's interest in the minerals represented by its royalty measured by gross production and its royalty measured by 20% of the net profits, when the entire fee title to the minerals would revert to petitioner upon abandonment, surrender or forfeiture of the lease by the lessee. In any such latter event the lessee would retain no interest in the minerals represented by the 20% of net profits provision.

This Court in *Dobson v. Commissioner,* 320 U. S. 489, held that a determination of the Tax Court as to whether particular transactions are integrated or separated for tax purposes is no more reviewable than any other question of fact. Here the Tax Court held that the lease and contract were for tax purposes all one transaction and agreed with petitioner's contention "that in granting the lease it (petitioner) retained for itself a 1/6 oil royalty and 20 per cent net profits from the operation of the lease each year" and that petitioner's gross income for depletion purposes was the 1/6 royalty and the 20% profits. These findings and the other findings were binding upon the Circuit Court of Appeals under the decisions of this Court in *Dobson v. Commissioner, supra, Wilmington Trust Company v. Helvering,* 316 U. S. 164, and *Choate v. Commissioner of Internal Revenue,* 324 U. S. 1. Such a rule is particularly salutary in a case like this in the interest of uniformity in applying the tax law. We refer particularly to the discussion on this in the footnote at pages 499-500 of 320 U. S. in this Court's opinion in *Dobson v. Commissioner.* As far back as 1932 the Board of Tax Appeals held[1] that where a landowner leased his land and obtained a royalty of a certain per cent of the net profits, he was entitled to depletion thereon. The Commissioner acquiesced in that case in 1933[2] and did not contend to the contrary until 1942 in the *Felix Oil Com-*

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[1] *Green v. Commissioner,* 26 B. T. A. 1017

[2] XII-1 C. B. 6.

pany case[3]. Both the Board of Tax Appeals and the Ninth Circuit held again that the landowner was entitled to depletion on the net profits reservation. The Tax Court in the present case made the same findings and for the sake of uniformity in the administration of the taxing statutes, the Circuit Court of Appeals under the authorities of this Court above referred to should not have substituted its own findings and inferences of fact for those of the Tax Court.

Since our petition for a writ of certiorari was filed this Court has handed down its opinion in *Bingham's Trust v. Commissioner of Internal Revenue*, 65 S. Ct. 1232. Frankly we are uncertain as to whether under the *Bingham* case the Circuit Court of Appeals was authorized or not to reverse the Tax Court. It would seem to us, however, that the Tax Court's findings that the two instruments were all one transaction is clearly conclusive. It would seem to us that the Tax Court's finding that petitioner received money under the 20% net profits provision because of its ownership of the oil and gas is likewise conclusive, and that the Circuit Court of Appeals had no authority to substitute a contrary finding that petitioner received that money merely by reason of "the personal covenant of the lessees to pay whatever amount of net profits became due by the lessees". (R. 43.) Nor do we

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[3] *Memorandum Decision by the Tax Court of December* 18, 1942, *not published in the regular reports but found as C. C. H. Decision* 12,920-*A of Commerce Clearing House, Inc.: Tax Court Service, and affirmed by the Ninth Circuit Court of Appeals in* 144 F. 2d 276 *from which the Commissioner took no appeal.*

see how the Circuit Court of Appeals had authority to find that petitioner retained no economic interest in the minerals in so far as the 20% was concerned when the Tax Court found that it did retain such interest.

Point B.

Petitioner Entitled to Depletion.

The majority opinion of the Circuit Court of Appeals confused the test of petitioner's right to depletion with the method of measuring its gross income upon which its depletion is to be computed and came to its erroneous conclusions, as was so forcefully and clearly pointed out by Judge Hutcheson in his dissenting opinion. The question is simple and also simple of solution if, as Judge Hutcheson said, we do not blindly point "with unwavering finger at the words 'net profits'" and then unreasoningly say "No" to petitioner.

Boiled down to its barebones facts, it is the same as if petitioner, the fee owner of the land, had executed an ordinary oil and gas lease and retained therein a royalty of 1/6 of the *gross* income from the minerals and 1/5 of the *net* income therefrom. Section 114(b)(3) provides that

> "the allowance (to petitioner) for depletion under Section 23(m) shall be 27½ per centum of the *gross income* (of petitioner) from the property during the taxable year".

This section is concerned with the *amount* of petitioner's gross income from the property and not with the formulas, methods, measures or standards that are

to be applied by the lessee and lessor in determining the amount to be paid petitioner by the lessee. Once the amount of the gross income of petitioner is determined by whatever method, the statute allows it a depletion deduction of 27½% of that amount, whether that amount is a percentage of the gross production of the minerals or the gross production less production expenses. The confusion of the Circuit Court of Appeals is illustrated by the following extract from the opinion of the majority (R. 41):

> "A taxpayer who leases solely for net profits no longer has a direct interest in the production of mineral deposits; his interest is in the ability of the operators to earn profits. It is true that there would be no net profits if there were no production; but since production could take place without there being any net profits, the taxpayer's income accrues after, not at the time of, the extraction of the oil and gas from the deposits."

The Circuit Court of Appeals apparently would read into Section 114(b) (3) a qualification so that section would provide as follows, the part in italics corresponding to the qualification of the Circuit Court of Appeals:

> "In the case of oil and gas wells the allowance for depletion under Section 23(m) shall be 27½ per centum of the gross income from the property during the taxable year, *provided such gross income is measured by a fractional part of the total gross income from the property.*"

There is no such qualification in the statute, and this Court in the *Mountain Producers Corporation*

case[4] has stated that the term "gross income from the property" means gross income from oil or gas and the term must be taken in its natural sense. This Court has said that this gross income is to be the measure of the base for depletion without regard to the particular kind of contract under which this gross income is determined as between the lessor and the lessee. This Court in that case, after pointing out that Congress had adopted percentage depletion to avoid complexities in determining cost depletion, said on page 382:

> "The rule being of this sort for obvious purposes of administrative convenience, we must apply it in the simple manner it contemplates. The 27½ per cent. allowed is a fixed factor, not to be increased or lessened by asserted equities. The term 'gross income from the property' means gross income from the oil and gas (Helvering v. Twin Bell Syndicate, supra) and the term should be taken in its natural sense. With the motives which lead the taxpayer to be satisfied with the proceeds he receives we are not concerned. If, in this instance, the development operations had failed to produce oil, it would hardly be said that the expense of drilling, borne under contract by another, constituted 'gross income' of the taxpayer within the meaning of the statute. Nor, when oil or gas is produced, does the statute base the percentage on market value. The gross income from time to time may be more or less than market value *according to the bearing of particular contracts.*"

We may also point out that the company claiming,

[4] *Helvering v. Mountain Producers Corporation*, 303 U. S. 376, 382.

and being allowed, depletion was entitled only to net profits from the leases involved and was allowed that depletion because its net profits came as income from the oil and gas produced. A company owned certain leases and made a contract with a refinery company to sell to the latter all of the oil produced from these leases, a regular schedule of prices being agreed upon. The contract then provided that the wells should be drilled and the properties operated by the refinery company, which would buy the oil and pay the company owning the leases the schedule of prices agreed upon less the costs of the refinery company in drilling the wells and operating the properties. The owner of the leases contended that it was entitled to percentage depletion upon the cash paid to it by the refinery company and the amount of expenses incurred by the latter in developing and operating the properties, claiming that these two items constituted its gross income. This Court held that it was entitled to depletion only on the cash received and that that was its gross income from the oil and gas in so far as depletion was concerned. In that case Mountain Producers Corporation received 100% of the net profits, and we fail to see why the petitioner in this case should be denied depletion merely because it received only 20% of the net profits.

Petitioner for the year involved received \$26,-223.70 under the net profits provision (R. 2 (par. A)). Whose income was this, that of petitioner or of the lessee? Petitioner included it in its gross income, and deducted the 27½% depletion of \$7,211.52. The

respondent classed it as taxable income of the petitioner, disallowing the depletion deduction. It is therefore clear that it was income of the petitioner. It was not even included by the respondent in the taxable income of the lessee. The respondent treated it as ordinary income. The $26,223.70 was not received by the petitioner as the proceeds of a sale of any interest in the property. If it were, then petitioner would have been entitled to deduct the cost of the interest in the property sold by it, which deduction it of course did not take. Likewise, if it were received by petitioner as part of the proceeds of the sale of an interest in the property, the same amount would be taxable to the lessee[5], but the respondent did not class it as taxable income of the lessee. Therefore, it was income of petitioner, and it was income as the result of production of oil and gas from petitioner's property, and it necessarily follows that it was "gross income from the property" of petitioner upon which the 27½%. depletion was to be computed.

The purpose of the depletion allowance is to allow an owner of an interest in the minerals to recover his cost thereof through his income from the minerals. In this case petitioner leased the land for a fractional royalty measured by gross production and a fractional royalty measured by net profits. It was all one income to petitioner which it obtained because it owned the minerals and was willing to execute a lease on these terms. In view of the record and of the findings of the Tax Court, the lease and contract were all one transac-

[5]*Helvering v. Elbe Oil Land Development Company*, 303 U. S. 372.

tion and are to be treated as if they were one instrument reserving a royalty of 1/6 of the gross and 20% of the net profits. We refer to the analysis of the contract set forth in footnote 4 of Judge Hutcheson's opinion, where he shows that under clause IV of the contract the lessor and lessee were both interested in all oil to be marketed from the premises and that this was not a mere personal obligation on the part of the first lessees but was a contract that was binding upon their successors in interest in the lease.

The opinion of the Circuit Court of Appeals says that the present case cannot be distinguished from the *O'Donnell, Anderson* and *Elbe Oil Company* cases[6]. We will refer to them later in this brief.

This Court in every case has held that, where a party owned an economic interest in the oil and gas as distinguished from merely an economic advantage through a contract, he was entitled to the depletion allowance through which to recover his capital investment, and the test laid down by this Court is whether such a party does have an economic interest in the minerals.

In two of the earlier cases[7], this Court held that a landowner upon executing a lease was entitled to depletion upon both the bonus and the royalties as a

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[6]*Helvering v. O'Donnell,* 303 U. S. 370; *Anderson v. Helvering,* 310 *U. S.* 404; *Helvering v. Elbe Oil Land Development Company,* 303 *U. S.* 372.

[7]*Burnet v. Harmel,* 287 U. S. 103; *Murphy Oil Company v. Burnet,* 287 *U. S.* 299.

source from which to recover his capital investment in the minerals.

In the next case[8] this Court had before it the question of whether a lessee, who upon assigning a lease received a cash bonus and retained an oil payment and an overriding royalty, was entitled to depletion on these items. This Court first referred to the nature of the lessor's right to depletion, saying on page 557:

> "Similarly, the lessor's right to a depletion allowance does not depend upon his retention of ownership or any other particular form of legal interest in the mineral content of the land. It is enough if, by virtue of the leasing transaction, he has retained a right to share in the oil produced. If so he has an economic interest in the oil, in place, which is depleted by production. Thus, we have recently held that the lessor is entitled to a depletion allowance on bonus and royalties, although by the local law ownership of the minerals, in place, passed from the lessor upon the execution of the lease. See Burnet v. Harmel, supra; Bankers Pocahontas Coal Co. v. Burnet, ante, p. 308."

It then referred to the specific case before it and, in holding the lessee-assignor entitled to depletion, said on page 558:

> "Thus, throughout their changing relationships with respect to the properties, the oil in the ground was a reservoir of capital investment of the several parties, all of whom, the original lessors, the two partnerships and their transferees, were entitled to share in the oil produced. Production and sale of the oil would result in its

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[8] *Palmer v. Bender*, 287 *U. S.* 551.

depletion and also in a return of capital investment to the parties according to their respective interests. The loss or destruction of the oil at any time from the date of the leases until complete extraction would have resulted in loss to the partnerships. Such an interest is, we think, included within the meaning and purpose of the statute permitting deduction in the case of oil and gas wells of a reasonable allowance for depletion according to 'the peculiar conditions in each case.''

The *Bankline Oil Company* case[9] is not even comparable to the present one. The taxpayer operated a casinghead gasoline plant for the extraction of gasoline from wet gas, and the only connection that it had with any production was that it had two types of contracts with producers of gas, under one of which the gas was delivered to the taxpayer who extracted the gasoline and agreed to pay the producer 1/3 of the gross proceeds from the sale of the gasoline or to deliver to him 1/3 of the gasoline, and under the other the taxpayer purchased outright from the producer all the natural gas and agreed to pay the producer 1/3 of the gross proceeds received from the sale of the extracted gasoline. There the taxpayer never had any remote interest in the minerals in place.

The *O'Donnell* case[10] was the first so-called net profits case decided by this Court. The taxpayer there never had any interest at any time in the oil and gas. He merely owned part of the stock of the

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[9] *Helvering v. Bankline Oil Company*, 303 *U. S.* 362.

[10] *Helvering v. O'Donnell*, 303 *U. S.* 370.

San Gabriel Petroleum Company, which he sold to Petroleum Midway Company, Ltd., and, as consideration for the payment for the stock, the Midway Company agreed to acquire the properties of the San Gabriel Company and pay the taxpayer 1/3 of the net profits from the operation of those properties. That is a far cry from the present case where petitioner was the land owner and in substance made a lease retaining a royalty measured by the gross production and another royalty measured by the net profits.

In the next so-called "net profits case"[11], which the lower court says cannot be distinguished from the present case, taxpayer did own an interest in certain oil and gas properties, but it made an absolute sale of all of its interest in those properties for $350,000 cash, $1,650,000 additional cash payable over a period of four years, and for the additional agreement by the purchaser to pay taxpayer 1/3 of the net profits resulting from the operation of the properties after the purchaser had recovered all its expenditures in the acquisition, development and operation of the properties. As pointed out by this Court on page 374, the agreement specifically provided that:

> "It is the intention of the parties to this agreement that the full ownership, possession and control of all the properties * * * shall be vested in Honolulu (purchaser) and Elbe shall have no interest in or to said properties * * * ."

This Court simply held that, after the execution of such contract, the taxpayer had no further interest

[11] *Helvering v. Elbe Oil Land Development Company*, 303 U. S. 372.

in the properties and received its net profits as part of the consideration for a sale of its interest.

In the third case that the lower court says cannot be distinguished[12] the owner of certain royalty interests, fee interests and deferred oil payments, sold the same to a purchaser for $50,000 cash and $110,000 to be paid from one-half the proceeds received by the purchaser from oil and gas produced from the properties and from the sale of the lands owned in fee, the seller retaining a lien upon all of the properties. The question involved was whether the *purchaser* should be required to include in his income the entire proceeds received from the oil and gas produced although one-half was paid to the seller. This Court held that this was a completed sale of the properties, that the purchaser obtained the entire interest and that the payments to the seller were merely by way of purchase price. We cannot see the applicability of that case to the present one.

One last case[13] will be referred to. Taxpayer owned certain leases and made a contract with an oil company under which the oil company was granted the right to go upon the leased properties, drill wells thereon and produce all the oil and gas therefrom at its own expense. The contract then provided that all the oil and gas should be delivered to the taxpayer, who would sell the same and pay the oil company two-thirds of the net proceeds, with the provision that if the lessor took its royalty of 5% in oil, the taxpayer would pay the oil company 66 2/3% of the net pro-

[12] *Anderson v. Helvering*, 310 *U. S.* 404.

[13] *Spalding v. U. S.*, 97 *F. 2d* 697.

ceeds. In that case the taxpayer was actually obtaining one-third of the net proceeds from the operation of the property with all operations and expenses being borne by the oil company. The taxpayer claimed the right to take depletion on the entire production instead of on one-third. The Government did not even contest the right to take depletion on the one-third but denied the depletion on the two-thirds because the oil company was the one entitled to depletion on that part, and the court sustained the position of the Government. It will be noted in that case that the taxpayer was allowed the depletion on the one-third interest owned by taxpayer.

In this case respondent owned the minerals in fee and at all times came more clearly within the economic interest test laid down by this Court than many taxpayers who have been allowed by this Court to take depletion. Petitioner was willing to make a lease but wanted to recover its capital investment in the property through a participation in the returns from the production of the depletable minerals. This took the form of a cash payment, a retained royalty and a participation in the net profits. The provision concerning net profits was merely a method of determining the part of the minerals or their proceeds that should be paid to the petitioner as the owner of the minerals in fee. In the preambles to the supplementary agreement, after a reference to the lease, it is recited:

> "The parties to said lease have agreed that Second Party shall be entitled to receive twenty per cent (20%) of the net money profits derived

by First Party from operations under said lease, said twenty per cent (20%) net money profits interest being specifically described and defined and payable as is hereinafter provided." (R. 30.)

Paragraph I of the contract then provided:

"Second Party, subject to the terms and provisions hereof and in the manner herein provided, shall be entitled to receive twenty per cent (20%) of the net money profits realized by First Party from its operations under and by virtue of the lease referred to above. The net money profits in which Second Party shall participate under the terms hereof, shall be calculated and determined and be payable as hereinafter provided." (R. 30.)

Paragraph IV provided:

"First Party (lessee) shall have exclusive charge and control of the marketing of all oil, gas and other minerals produced from said premises, *and in which the parties hereto may be interested.* Upon the sale of any of such minerals, the accounts covering the lease referred to above, shall be credited with the proceeds of such sales * * * ." (R. 32.)

Paragraph V provided:

"Second Party (petitioner) shall participate in the profits *derived from the sale of the oil and gas and other mineral production of the lease* embraced in this agreement only after all charges and debits and costs of producing profits shall have been paid and provided for. * * * ." (R. 33.)

Paragraph IX provided:

"This contract shall be binding upon the parties hereto and their respective successors in interest." (R. 34.)

This contract shows in detail that the amount received by petitioner under the 20% provision was directly out of income from the oil and gas produced from the property owned by petitioner in fee, even if this were not self-apparent otherwise, and petitioner's right to that income arose from its interest in the oil itself and not by virtue of a mere personal covenant of the lessee. We respectfully refer to Judge Hutcheson's detailed analysis of the contract. (R. 45-48.)

This contract and the lease merely provided for the total return by way of income from the production of petitioner's minerals that petitioner was to receive. It received this total amount because of its fee ownership of the minerals. Certainly, no one can have a greater economic interest in minerals than the fee owner thereof, and it is respectfully submitted that petitioner under every test laid down by the courts is entitled to the 27½% depletion upon the amounts received by it under the 20% net profits agreement.

We refer briefly to the statement of the court below that, if depletion were allowed on the net profits, the depletion could not be ascertained until the amount of net income is determined and that "This poses an abstruse problem instead of the rule of thumb that the arbitrary percentage-depletion allowance was intended to be." We see no abstruse problem involved. The statute says that petitioner will be allowed a depletion of 27½% of its gross income. We see no difficulty in computing the 27½% allowance upon the income that was received by petitioner from the 20% provision. The amount received in the year in-

volved was $26,223.70, and 27½% of that was $7,-211.52. (R. 23.) Judge Hutcheson in his dissenting opinion found no difficulty in determining petitioner's allowance on this basis, saying "the 20 percent payment it received constituted, under *Helvering v. Producers,* 303 U. S. 382, the 'gross income' on which its depletion must be taken." We see no obstruse problems or involved administrative difficulties that might arise.

Every court that has passed upon a similar net profits provision has held that the income therefrom was subject to depletion. The Board of Tax Appeals as early as 1932[14] had an exactly similar case and allowed the depletion claimed. The Commissioner in 1933[15] acquiesced in that case, and did not withdraw that acquiescence until 1942[16] after the present case arose in the Bureau of Internal Revenue. In 1944 the Ninth Circuit Court of Appeals[17] affirmed the Tax Court in allowing the landowner depletion where the royalty reserved by it in its lease consisted solely of 50% of the net profits of the lessee. In that case if the landowner had been denied depletion, it never could have recovered any part of its cost of the minerals as the royalty retained by it was measured entirely by net profits. In a later similar case[18] the Ninth Circuit Court of Appeals had a net profits case similar to that of the *Felix Oil Company* and the present one of this

[14] *W. S. Green v. Commissioner,* 26 B. T. A. 1017.

[15] *XII*-1 C. B. 6.

[16] 1942-1 C. B. 23.

[17] *Commissioner v. Felix Oil Company,* 144 F.2d 276.

[18] *Commissioner of Internal Revenue v. Crawford,* 148 F.2d 776.

petitioner, and allowed the depletion claimed, affirming the Tax Court, following its holding in the *Felix Oil Company* case, and refusing to follow, and criticising, the opinion of the Circuit Court of Appeals in this case. See also *Commissioner of Internal Revenue v. Caldwell Oil Corporation,* 141 F.2d 559 (Fifth Circuit Court of Appeals); *Marrs McLean,* 41 *B.T.A.* 565, 574 (depletion allowed on percentage of net profits received under the Gray leases, affirmed on other issues, *McLean v. Commissioner of Internal* Revenue, 120 F.2d 942).

The action of the Circuit Court of Appeals in this case will in itself, if not reversed, cause great confusion in the oil industry, and is an unrealistic approach to the question. It seems to be of the opinion that gross income on which a landowner is entitled to depletion must be by way of a royalty represented by a fraction of the gross production. In the early stages of oil development practically the only kind of royalty reserved by a landowner in a lease was 1/8 of the gross production. However, this is no longer the situation, and landowners, when they execute a lease, are having many different kinds of royalties reserved, each one depending upon the kind of trade the landowner can make with the lessee. Summers[19] sets out the many forms of oil, gas and mineral leases currently used. Royalty on gas is never 1/8 of the gas but is always 1/8 of the proceeds of the gas, or some other fraction[20]. Royalty on sulphur is never measured by a fraction of the gross production or the gross value but

[19] *Summers, Oil & Gas,* 1939 Edition, Vol. 7.

[20] *Summers,* Vol. 7, pages 266, 270, 274, 280, 290, 294.

is always a fixed number of cents per ton[21]. With the development of processes for extracting gasoline from gas, whether from gas wells or casinghead gas from oil wells, a further source of profit was developed, but owing to the complicated arrangements necessary for running such gas through extraction plants, no simple royalty measured by gross was workable and the income of the landowner from the gasoline extracted and the residue gas is generally measured by a portion of the net profits from such operation or a price per gallon of gasoline obtained, depending upon sliding schedules. Likewise landowners have become more insistent upon having, in addition to an assured return measured by gross production, an additional opportunity to share in the net profits, just as was done by Felix Oil Company and petitioner in this case.

In rejecting petitioner's claim the majority opinion of the court below said in part (R. 43):

> "If net profits, which cannot be computed or paid until they are earned, are rents and royalties within the meaning of Section 114(b) (3), the depletion allowances on the working interest cannot be ascertained until the amount of net income is determined. This poses an abstruse problem instead of the rule of thumb that the arbitrary percentage-depletion allowance was intended to be."

We respectfully submit that there is no such abstruse problem posed. It is a simple matter to examine the books of petitioner, or of any landowner having any of the varied types of arrangements with his lessee

[21] *Summers*, pages 266, 271, 275, 280, 291, 295.

above outlined, to determine how much money he has received from his lessee during the year as income under his contract with his lessee, and the allowable depletion is simply 27½% of this amount. On the other hand, if the decision of the lower court is affirmed in this case, it would seem to us to follow that all of the varied deals made between landowners and their lessees will be thrown into confusion and there will then follow real abstruse legal problems to determine which landowner is entitled to depletion and which one is not. This Court has already solved these abstruse legal problems when it said in the *Mountain Producers Corporation* case, [22] supra,

> "The term 'gross income from the property' means gross income from the oil and gas (Helvering v. Twin Bell Syndicate, supra) and the term should be taken in its natural sense. With the motives which lead the taxpayer to be satisfied with the proceeds he receives we are not concerned * * * *. The gross income from time to time may be more or less than market value *according to the bearing of particular contracts.*"

Conclusion.

It is respectfully submitted that the judgment of the Fifth Circuit Court of Appeals should be reversed and that of the Tax Court of the United States should be affirmed.

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[22] *Helvering v. Mountain Producers Corporation*, 303 U. S. 376, 382.